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Banks – Back to Market Weight

Our weekly view on Australian equities.

26 August 2021

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Our Outlook for the Banks

We have pulled back our overweight banks call following a period of sustained outperformance. Key factors that have driven bank outperformance are now fading or are embedded in the consensus view and the prospect of further outperformance is now more balanced than it was 6-12 months ago.

We have reduced our weighting in ANZ Banking Group (ANZ), with 'part one' of ANZ's capital management program having now played out. ANZ's balance sheet has not grown since 1H21, suggesting the prospects of above sector earnings growth in FY22E and FY23E look more challenging. At a sector level, the Wilsons Australian Equity Focus List is now market weight the banks.

We have lifted our weight in Insurance Australia Group (IAG) to 5% from 3%. Over the past 18 months, IAG's share price has fallen 30% due to a wall of bad news. With many stock-specific issues now fading, we think IAG can play catch-up with the rest of the insurance sector in FY22E. The insurance sector is benefiting from an acceleration in premium growth that has lifted profitability from cycle lows.

Like IAG, we think EML Payments' (EML) operational issues are largely behind us, particularly the regulatory issue in Ireland that, at its worst, resulted in ~$A1bn of market capitalisation being eroded from the stock. Earnings guidance has now been reset. In our view, revenue momentum should reassert itself through FY22E as cross border travel re-starts. We have increased our weighting in EML to 4% from 2%.

Bank Mini Reporting Season

The bank mini reporting season over the past few weeks delivered on several operating trends:

- Improved system-wide credit growth lifted bank balance sheet growth.
- Net interest margins remained under pressure due to low rates and competition.
- Trading/market income and expense trends were generally worse than expected.

Bank earnings continued to be supported by lower bad debts and impairment charges (the lack of). Capital management featured, with all major banks announcing share buy-backs; or in the case of Westpac Banking Corporation (WBC), the intent – likely in the form of an off-market buy-back in November 2021.

Regional peer Bendigo's (BEN) FY21 result highlighted a number of these challenges, with outlook comments reflecting a soft outlook for margins and sticky cost growth. The BEN share price fell 10% in response, significantly underperforming the majors.

For the sector overall, consensus pre-provision earnings saw single digit downgrades over the past month.

Exhibit 1: Summary of operating trends across the major banks

Bank	Period	Revenue	Core Earnings	Margins	Provisions	Capital	ISG Overal Score
ANZ	3Q21				Strong Improvement	Soft	
CBA	2H21	Improving	Steady	Steady	Strong Improvement	Steady	Steady
NAB	3Q21	Soft	Soft	Improving	Strong Improvement	Soft	Improving
WBC	3Q21		Falling		Strong Improvement	Steady	Soft

Source: Refinitiv, Wilsons. ANZ/WBC provided Pillar 3 updates only.

Earnings Outlook

Cash earnings for the banks have now recouped just over half the COVID losses. After the rebound in earnings in FY21E (no large-scale bad debt provisions), the market currently expects earnings to grow in the mid- single-digit level through to FY24E.

We think there is some upside risk to cash earnings per share (EPS) with further capital management initiatives, which do not look to be fully reflected in market estimates. Our sense though is that potential capital management prospects are largely built into share prices.

In our view, it is unlikely that COVID lockdowns in NSW, VIC and NZ have a material impact on bad debts or the ability of provisions to be written back in coming years. The key difference in 2021 vs 2020 is the relative lack of employment shedding that is taking place.

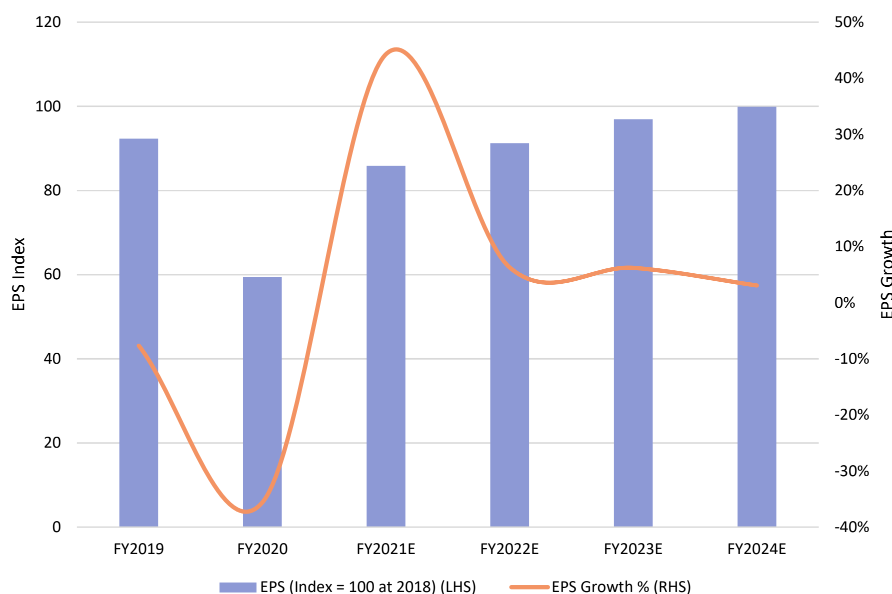
There remains ample room for provision write-backs as the recovery takes a firmer footing in FY22E-23E. Provision coverage across the major banks sits at 1.4% of total assets, down from a peak of 1.5-1.6% in FY20. With bad debt costs not expected to be more than 0.15% of assets in any given year into FY24E, there could be a 2-3% additional upside in bank earnings on faster provision write back.

Finally, consensus expects that return on equity (ROE) will hover around the 12-13% level over the next 3-years. The market is only assuming earnings return to FY19 levels, whilst the capital bases normalise post-COVID. While the FY19 earnings base contains earnings from several assets that have subsequently been divested (representing 10-15% of industry earnings), it does not strike us as being a particularly ambitious earnings profile if banks can show a combination of better revenue and cost performance. Something which has been hard to achieve over the last few years.

To be sure, net interest margin pressure remains a feature in forecasts, and if we saw some relief on this front, both bank earnings and ROE would be materially higher.

The outlook for dividend growth also moderates in FY22E. Payout ratios across ANZ, NAB, WBC reach 70%, with CBA at 80%. Consensus has payout ratios flat into FY24E, reflecting bank guidance. Dividend growth will match earnings growth. To be sure, there remains some upside to dividends with an allowance for further buy-backs.

Exhibit 2: EPS growth is expected to average ~5% FY22-24E



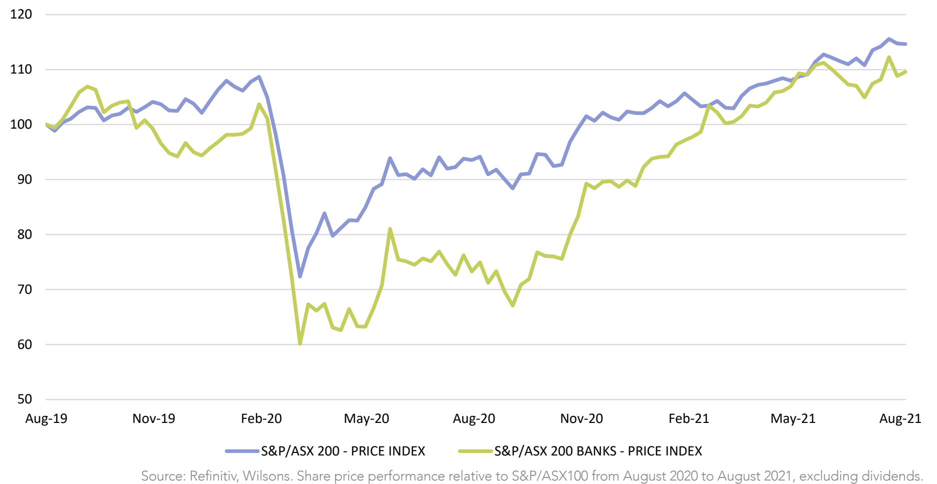
Source: Refinitiv, Wilsons.

Bank Valuations have Largely Normalised

Bank share prices have outperformed the market by around 20% over the past 12 months. Interestingly, CBA has been the laggard since August 2020 (it did not fall as far during 1Q20 and avoided raising common equity).

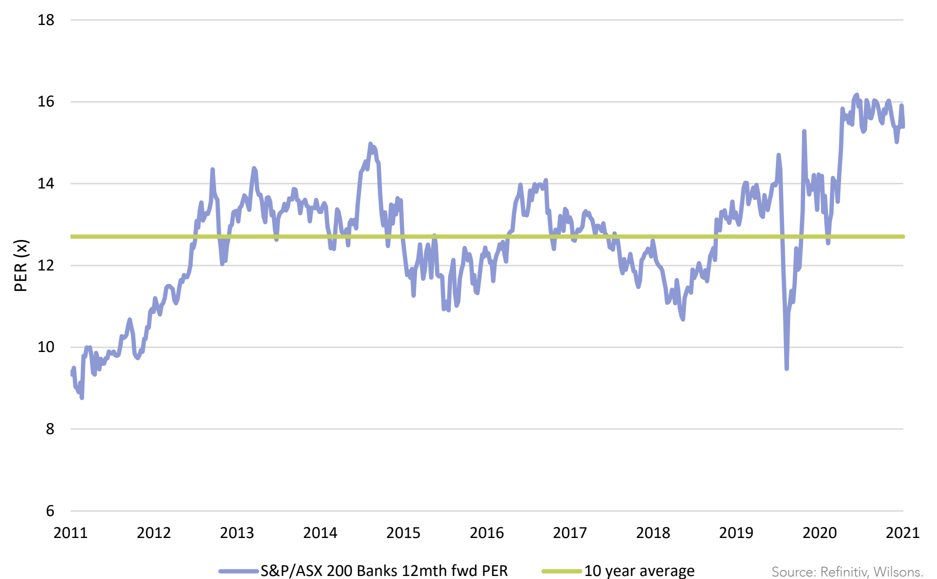
The strong moves in share prices have resulted in bank valuations looking more 'normal' across a range of measures. To be clear, the significant 'head room' in consensus earnings estimates we observed in late 2020 does not exist today. That makes it more challenging to 'look through' elevated earnings multiples in search of value. On a sector relative basis, the challenge becomes even greater, as the earnings improvement journey post-COVID is still very early (or yet to even begin) in some sectors.

Exhibit 3: Major bank share prices have strongly outperformed the market over the past 12 months



Source: Refinitiv, Wilsons. Share price performance relative to S&P/ASX100 from August 2020 to August 2021, excluding dividends.

Exhibit 4: Bank PER Ratios have reached multi-year highs, with less available headroom for earnings upgrades relative to late 2020



Source: Refinitiv, Wilsons.

Exhibit 5: Bank PER Rel vs the market has narrowed considerably over the past 12 months

Source: Refinitiv, Wilsons.

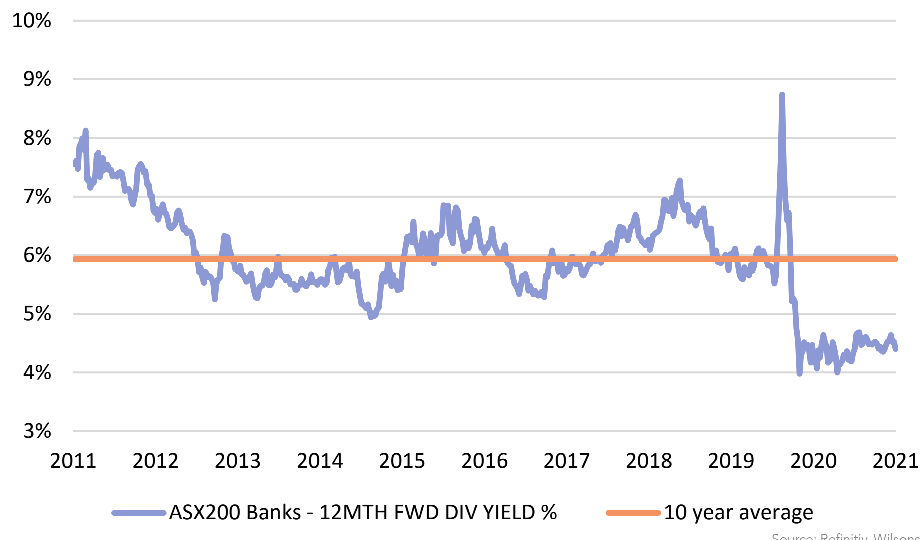
Surplus Capital - Further to Play Out

All banks have started on the return of surplus capital journey except WBC, which has flagged November. We estimate CBA and NAB are approximately halfway through their surplus capital, noting that NAB is spending $A1.3bn of capital to purchase Citibank's credit card business, effectively reducing its excess capital.

Assuming the banks continue along this capital management journey, we estimate over FY22E and FY23E cash EPS could be upgraded 1.5-3.0% in each year, and over 4.0% for WBC – given it is yet to commence a capital return program.

We think this surplus capital program is well understood by the market and for the most part is likely to be factored into market pricing. Another reason we are now comfortable to be market weight the banks.

Exhibit 6: Despite share price gains, bank dividend yields have remained largely flat as dividends were restored.



Source: Refinitiv, Wilsons.

Exhibit 7: Major bank price to book valuations are now around the 5yr average

Source: Refinitiv, Wilsons.

Exhibit 8: We estimate CBA and NAB are half-way through their surplus capital programs. WBC is yet to begin.

		ANZ	CBA	NAB	WBC
CET1 pro-forma*	**%**	**12.3**	**12.2**	**12.2**	**12.8**
Risk weighted assets*	$Abn	412	451	418	437
Share Price	$A	28.40	99.91	27.39	25.91
Market Cap	$Abn	80.8	177.25	90.35	95.053
Shares on Issue	m	2,846	1,774	3,299	3,669
Implied Surplus @ CET1 11%	**$Abn**	**5.4**	**5.4**	**5.0**	**7.9**
% of Mcap	%	6.6%	3.1%	5.6%	8.3%
Current buyback program	**$Abn**	**1.5**	**6.0**	**2.5**	**n/a**
Current program % as total program#		22%	53%	51%	n/a
Buyback					
FY22 EPS buyback accretion^	**%**	**3.3%**	**1.5%**	**2.8%**	**4.1%**

*August Bank Updates. Pro-forma adjusted for buy-back announcemnts.

^ assumes surplus capital is returned evenly between FY22 and FY23.

Wilsons estimate of total surplus capital. NAB we assume the Citi Credit Card acqusistion goes ahead.

Focus List: Banks Back to Market Weight

We have reduced our banks call from overweight to market weight. With sector valuations now closer to normal and less head room on earnings recovery and capital management, in our view, banks are more likely to perform in-line with the market going forward.

The Focus List was 1.2x overweight the banks. We have reduced our weight in ANZ from 7% and 3%. ANZ has been amongst the top two performing banks over the past 12 months. While ANZ is still early in its capital management program, it has less 'catch-up' to do from an operating performance perspective.

The current $1.5bn on-market buy-back program (~15% complete) is soaking up ~20% of the daily volume. We think both NAB (7% weight) and particularly WBC (9% weight) have more to offer in terms of sector 'catch-up', which we believe can help relative performance within the sector.

Switching into Insurance Australia Group (IAG) and EML Payments (EML)

We have lifted our weight in IAG from 3% to 5%. Through results season, the common theme from all insurance players was around increased premium growth. Whilst IAG is not yet participating in this growth to the degree we think is possible, that should change in FY22E and FY23E as the legacy issues/ management distractions of 2019-21 fade.

We are increasingly comfortable that our work around IAG provisioning levels implies potentially close to $A1bn in surplus capital.

Read Insurance Australia Group: How Fears Could be Overplayed

While the market is unlikely to pay up for improvement or capital returns in the short-term, we see a pathway for earnings for return to FY19 levels into FY23E. With multiple re-rate points over FY22E and a +4.0% dividend yield, the set-up for IAG reminds us of major banks in late 2020.

EML is a market confidence recovery story. We have lifted our weight from 2% to 4%. The stock price remains almost 25% below levels seen before the regulatory issue in Ireland in May 2021. With that issue materially less worrisome than the markets initial fears, we believe EML can recapture the confidence of the market.

Its core business remains exposed to structural trends within fintech of non-banks payments growth. Cash on the balance sheet of $A140m provides an additional level of comfort.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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